

Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Mark H. Howard
Senior Counsel (Salt Lake City)
(Small Business/Self-Employed)

from: Ashton P. Trice
Chief, Branch 2
(Procedure & Administration)

subject: Section 6676 Penalty and Form 1099-OID Schemes

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Does the erroneous claim for refund or credit penalty under section 6676 apply to a claim for refund of overstated amounts of income tax that a Form 1099-OID falsely represented as being withheld?

CONCLUSION

Whenever an underpayment results from overstated withholding credits of this type, the section 6676 penalty cannot apply. Typically, when a taxpayer falsely claims withheld income tax on a Form 1099-OID and seeks a refund of that tax, an underpayment will result and accuracy-related or fraud penalties will apply.

FACTS

The Service has received a number of returns to which taxpayers attach fabricated Forms 1099-OID to overstate claimed credits for income tax withheld at the source. These taxpayers generally file income tax returns that report the face amount of income on the Forms 1099-OID either on the Form 1040 lines for interest income or

for other income. This amount of income is carried through the returns to the computations of adjusted gross income and taxable income. But these taxpayers generally report no tax due. They list the amount of income stated on the face of the Forms 1099-OID as income tax withheld and then claim refunds based on that false amount withheld.

You have requested guidance whether the section 6676 penalty for filing an erroneous claim for refund or credit applies to these claims.

LAW AND ANALYSIS

Section 6676 imposes a penalty on any claim for refund or credit of income tax that is excessive in amount and lacks a reasonable basis for the claim. The penalty is equal to 20 percent of the excessive amount of the claim. The excessive amount is the disallowable portion of the claim for refund or credit.

Under the facts stated above, the entire amount of a refund claim is an excessive amount; the entire refund claim is disallowable because it is based upon a representation that income tax was withheld, but it actually was not. Also, there is no reasonable basis for the claim because this claim is fabricated.

However, the section 6676 penalty does not apply to any portion of a claim to which the accuracy-related penalty on underpayments under section 6662 or the fraud penalty under section 6663 applies.¹ Those penalties apply when an “underpayment” of tax, as defined in section 6664, arises. Therefore, if an “underpayment” exists, the section 6676 penalty cannot apply.

The section 6664 regulations define an underpayment of income tax as the amount by which any income tax imposed under Subtitle A exceeds the excess of (A) the sum of (i) the amount shown as the tax by the taxpayer on his return, plus (ii) amounts not so shown previously assessed (or collected without assessment), over (B) the amount of rebates made. Treas. Reg. § 1.6664-2(a). The definition can be expressed as: Underpayment = $W - (X + Y - Z)$, where W is the amount of income tax imposed,² X is the amount shown as tax by the taxpayer on his return,³ Y is amounts

¹ The section 6676 penalty also does not apply when a reportable transaction understatement penalty applies under section 6662A. See IRC § 6676(c). That penalty does not apply to the facts stated because the facts do not involve a reportable transaction.

² The *Amount of Income Tax Imposed* for purposes of section 6664 is the actual amount of income tax imposed, not including (A) the credits for tax withheld on wages at the source under section 31 and withheld at the source (for nonresident aliens and foreign corporations) under section 33, (B) any payments of tax or estimated tax made by the taxpayer, (C) any credit resulting from amounts collected as the result of a termination assessment or a jeopardy assessment, and (D) any tax the taxpayer is not required to assess on the return. Treas. Reg. § 1.6664-2(b).

³ The *Amount Shown as the Tax by the Taxpayer on his Return* for purposes of section 6664 is (1) the tax liability that the taxpayer reports on the return (not including exceptions A – C listed in Footnote 2), reduced by (2) the excess of (i) the sum of the amounts shown by the taxpayer on his return as (a) credits for income tax withheld under section 31 and 33, (b) estimated tax payments and (c) payments made by

not so shown previously assessed (or collected without assessment),⁴ and Z is the amount of rebates made.

The term *Amount of Rebates Made* for purposes of IRC § 6664 means so much of an abatement, credit, refund or other repayment, as was made on the ground that the tax imposed was less than the excess of (1) the sum of (a) the amount shown as the tax by the taxpayer on his return, plus (b) the amounts not so shown previously assessed (or collected without assessment), over (2) the rebates previously made. Treas. Reg. § 1.6664-2(e).

If the Service does not pay a refund under the scheme stated in the facts, there is no rebate. If the Service erroneously refunds tax on the basis that a taxpayer has claimed withholding of tax on a Form 1099-OID that is more than tax actually withheld, the refund is not paid on the ground that the tax imposed is less than the amount shown as tax by the taxpayer on the return. Instead, the refund is paid as a result of an error in determining the proper credit for withheld tax. See Treas. Reg. § 1.6211-1(f). Because any amount refunded is a nonrebate erroneous refund, it is not a rebate for purposes of section 6664 and will not factor into the computation of an underpayment under section 6664.

Under the facts stated, the overstatement of income tax withheld decreases the *amount shown as tax by the taxpayer on his return*, as defined in Treas. Reg. § 1.6664-2(c), and increases the underpayment, if any, of tax. See Treas. Reg. § 1.6664-2(g), *Example 3*; see also Sadler v. Commissioner, 113 T.C. No. 4 (1999); Rice v. Commissioner, T.C. Memo. 1999-65. Thus, in a case where the only inaccuracy on a return is a claim of false withholding, an underpayment results and section 6676 cannot apply.⁵

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the taxpayer for a taxable year prior to the filing of the return for such taxable year, over (ii) the sum of the (a) amounts actually withheld under section 31 and 33, (b) amount actually paid as estimated tax, and (c) amounts actually paid with respect to a taxable year before the return for such year is filed. Treas. Reg. § 1.6664-2(c).

⁴ The term *Amount Not So Shown as Previously Assessed (or Collected Without Assessment)* consists of two parts: (1) the amounts not so shown as previously assessed, and (2) the amounts not so shown as previously collected without assessment. The amounts not so shown as previously assessed means only amounts assessed before the return was filed that were not shown on the return (e.g., termination or jeopardy assessments). The term amounts not so shown as previously collected without assessment is the amount by which (1) the sum of (a) the credits allowable for tax withheld on wages, (b) the credits allowable for tax withheld at the source, (c) the amount of estimated tax payments, and (d) the amount of other payments in satisfaction of tax liability made before the return is filed, exceed (2) the tax shown on the return (provided that the excess has not been refunded or allowed as a credit to the taxpayer). Treas. Reg. § 1.6664-2(d).

⁵ Where there are other inaccuracies on the return, including calculations of more tax due than the Code imposes or failure to claim actual credits to which one is entitled, it is possible that an underpayment may not arise. Thus, care should be taken in determining which penalty applies from case to case.